tax regime applicable to individuals who are no longer physically present in the country, and whose assets may no longer be situated in the country or under the control of any U.S. person, inevitably faces serious challenges of enforcement as a practical matter. This enforcement effort requires significant resources to be devoted to the few individuals who are subject to the alternative tax regime. Accordingly, the Joint Committee staff believes that careful consideration should be given as to whether the alternative tax regime and related immigration rules, even as modified by the recommendations set forth below, can fully achieve the goals that the Congress intends to accomplish.[578]

The Joint Committee staff recommendations are discussed in detail below.

A. Recommendations Relating to the Tax Treatment of Citizenship Relinquishment and Residency Termination

1. Provide objective rules for the alternative tax regime

The Joint Committee staff recommends that objective rules replace the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law. Under the proposed objective rules, a former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident:

(a) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $122,000 (adjusted for inflation after 2003) and his or her net worth does not exceed $2 million, or alternatively satisfies limited exceptions for dual citizens and minors who have had no substantial contact with the United States, and

(b) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the five preceding years and provides such evidence of compliance as the Secretary of the Treasury may require.

<u>**Background**</u>

One of the major difficulties in administering the present-law alternative tax regime is that the IRS is required to determine the subjective intent of taxpayers who relinquish citizenship or terminate residency. The present-law presumption of tax-avoidance purpose in cases in which objective income tax liability or net worth thresholds are exceeded mitigates this problem to some extent. However, the present-law rules still require the IRS to make subjective determinations of intent in cases involving taxpayers who fall below these thresholds, as well for

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[578] *See* Part VI, above, for background on the purposes of a special tax regime for former citizens and former long-term residents.

certain taxpayers who exceed these thresholds but are nevertheless allowed to seek a ruling from the IRS to the effect that they did not have a principal purpose of tax avoidance.[579]

Joint Committee staff recommendation

The Joint Committee staff recommends that objective rules replace entirely the subjective determination of tax avoidance as a principal purpose for citizenship relinquishment or residency termination under present law. Under the Joint Committee staff recommendation, a former citizen or former long-term resident would be subject to the alternative tax regime for a 10-year period following citizenship relinquishment or residency termination, unless the former citizen or former long-term resident: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $122,000 (adjusted for inflation after 2003) and his or her net worth does not exceed $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all U.S. Federal tax obligations for the preceding five years and provides such evidence of compliance as the Secretary of the Treasury may require.

Objective monetary thresholds for determination of tax-motivation

This recommendation, like present law, retains an income tax liability test and a net worth test, but it departs from the present-law approach in two significant respects. First, the objective monetary thresholds would become the general rule for conclusively determining whether a former citizen or former long-term resident would be subject to the alternative tax regime. The monetary thresholds would serve as a proxy for tax motivation and, unlike present law, no subsequent inquiry into the taxpayer's intent would be required or permitted. The ruling process of present law would be eliminated.

Second, because this objective monetary standard would be less flexible than present law, the present-law amount for the net-worth threshold would be increased. Raising the net-worth threshold would mitigate concerns about subjecting non-tax-motivated individuals to the alternative tax regime, since tax savings generally are more significant, and hence tax motivation more likely, in cases involving high net-worth individuals. Because estate and gift taxes are often the principal motivating factors for persons who relinquish citizenship or terminate residency for tax-avoidance purposes, the net-worth threshold would be set at a level at which substantial liability may arise under the estate and gift tax rules. The recommended net worth threshold of $2 million is twice the unified credit exclusion-equivalent amount for gift tax purposes, a level above which the transfer tax can be significant enough to be a motivating factor for relinquishing citizenship or terminating residency.[580] The Joint Committee staff believes that

[579] Sec. 877(a), (c).

[580] Under present law, the unified credit exclusion equivalent amount for gift tax purposes is $1 million, even for years in which the amount increases for estate tax purposes, for the year in which the estate tax is repealed, and for the years following the sunset of EGTRRA. If changes are made to the estate and gift tax rules in this regard, it may be appropriate to consider correlative adjustments to the net worth threshold.

the income tax liability threshold under present law is set at an appropriate level to target income tax avoidance as a motivating factor, and thus the recommended level of $122,000 simply reflects the inflation-adjusted present-law amount.[581]

The net worth test also would serve as a backstop to the income tax liability test in cases in which income tax avoidance may be the motivating factor, regardless of whether transfer tax avoidance is also an important factor. For example, an individual with a large, highly appreciated securities portfolio might be motivated by income tax avoidance to relinquish citizenship, but such an individual would not necessarily be paying high levels of current income tax, and thus might not exceed the income tax liability threshold. The individual's large amounts of unrealized appreciation would, however, cause the individual to exceed the net worth threshold. For this reason, a net worth test may be desirable even if estate tax repeal were made permanent, or if the estate and gift taxes were both permanently repealed.[582]

Exceptions for certain dual citizens and minors with no substantial contact with the United States

The Joint Committee staff recommends that the alternative tax regime not apply to a former citizen who is a dual citizen or a minor with no substantial contacts with the United States prior to relinquishing citizenship. These exceptions for dual citizens and minors would use the present-law definitions of such individuals,[583] but the exceptions would operate differently from the present-law rules, which require an inquiry into intent. Under the recommendation, even if a former citizen or former long-term resident exceeded the monetary thresholds, that person would be excluded from the alternative tax regime if he or she fell within one of the specified exceptions (provided that the requirement of certification and proof of compliance with Federal tax obligations is met, as described below). Thus, narrow, objective exceptions for cases particularly likely to involve significant non-tax motivation would replace the intent-based inquiry applicable to these cases under present law. These exceptions are described below.

Certain dual citizens.–The Joint Committee staff recommends an exception from the alternative tax regime for an individual who has been a dual citizen of the United States and a foreign country since birth, and who has had no substantial contacts with the United States. A person would be treated as having no substantial contacts with the United States only if the person: (1) was never a resident of the United States (within the meaning of section 7701(b), as modified by any applicable treaty); (2) has never held a United States passport; and (3) was not present in the United States for more than 30 days during any one of the 10 calendar years preceding relinquishment of citizenship.

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[581] Sec. 877(a)(2)(A); Rev. Proc. 2002-70, 2002-46 I.R.B. 845.

[582] Alternatively, a test based on unrealized appreciation may be appropriate in that scenario, since such a test would target a characteristic more directly relevant to income tax avoidance.

[583] Secs. 877(c)(2)(A) and 877(c)(2)(C), respectively.

Certain minors.–The Joint Committee staff recommends an exception from the alternative tax regime for an individual who: (1) was born to parents who were not U.S. citizens (and thus who became a U.S. citizen solely by virtue of being born in the United States); (2) relinquished U.S. citizenship prior to age 18½; and (3) was not present in the United States for more than 30 days during any one of the 10 calendar years preceding relinquishment of citizenship.

Certification and proof of compliance with U.S. Federal tax obligations

In order to be excepted from the application of the alternative tax regime under the Joint Committee staff recommendation, whether by reason of falling below the net worth and income tax liability thresholds or qualifying for the dual-citizen or minor exceptions, the former citizen or former long-term resident also would be required to certify, under penalties of perjury, that he or she has complied with all U.S. Federal tax obligations for the five years preceding the relinquishment of citizenship or termination of residency and to provide such documentation as the Secretary of the Treasury may require evidencing such compliance (e.g., tax returns, proof of tax payments).[584] If such a certification could not be made, the individual would be required to take the necessary steps in consultation with the IRS to come into compliance with his or her U.S. Federal tax obligations in order to qualify for exception from the alternative tax regime. Until such time, the individual would remain subject to the alternative tax regime. The IRS would continue to have the right to verify that the information submitted was accurate, and it would be expected that the IRS would randomly audit such persons to assess compliance.

2. Provide tax-based rules for determining when an individual is no longer a U.S. citizen or long-term resident for U.S. Federal tax purposes

> **The Joint Committee staff recommends that an individual should continue to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes until the individual:**
>
> **(a) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Department of State or the INS, respectively, and**
>
> **(b) files a complete and accurate IRS Form 8854 (i.e., files a tax information statement in accordance with the requirements of section 6039G).**
>
> **In addition, the Joint Committee staff recommends that the Department of State (including U.S. consular offices) should be required to provide a uniform tax information statement (i.e., IRS Form 8854) to all individuals who seek to terminate their U.S. citizenship.**

[584] The recommendation is limited to five prior years in order to make the rule administrable from both the taxpayer's and the IRS's perspectives.

Background

Under present law, the Immigration and Nationality Act governs the determination of when a U.S. citizen is treated for U.S. Federal tax purposes as having relinquished citizenship.[585] Similarly, an individual's U.S. residency is considered terminated for U.S Federal tax purposes when the individual ceases to be a lawful permanent resident under the immigration law (or is treated as a resident of another country under a tax treaty and does not waive the benefits of such treaty). In view of this reliance on immigration-law status, it is possible in many instances for a U.S. citizen or resident to convert his or her Federal tax status to that of a nonresident noncitizen without notifying the IRS.

Although individuals who relinquish their citizenship or terminate their residency are required to provide tax information statements (e.g., on Form 8854), difficulties have been encountered in enforcing this requirement, and in many cases the IRS does not receive timely information that it needs to administer the alternative tax regime.[586] In these cases, an individual may become a non-resident non-citizen of the United States for Federal tax purposes -- and enjoy reductions in U.S. taxes from such tax status -- despite failing to provide the tax information statements necessary for the IRS to monitor and enforce compliance with the alternative tax regime.

Joint Committee staff recommendation

The Joint Committee staff recommends that an individual should continue to be treated as a U.S. citizen or long-term resident for U.S. Federal tax purposes[587] until the individual: (1) gives notice of an expatriating act or termination of residency (with the requisite intent to relinquish citizenship or terminate residency) to the Department of State or the INS, respectively;[588] and (2) files a complete and accurate tax information statement with the IRS (using Form 8854).

In addition, in order to enforce the alternative tax regime effectively, the IRS must obtain the required information as completely and consistently as possible. Accordingly, the Joint Committee staff recommends that the Department of State (including U.S. consular offices) be required to provide a uniform tax information statement (i.e., IRS Form 8854) to all individuals who seek to terminate their U.S. citizenship. The consular offices would be instructed to have

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[585] 8 U.S.C. section 1481. See Treas. Reg. sec. 1.1-1(c).

[586] *See* Part VII.B.3, above.

[587] Treatment as a U.S. citizen or long-term resident should be for all purposes of the Code, including section 7701(b)(10).

[588] As discussed in Part V, above, the Homeland Security Act transfers the functions of the INS and the immigration functions of both the Attorney General and the Secretary of State to the Department of Homeland Security. For clarity of exposition, the discussion in this Part XI continues to refer to the separate agency functions, since the mechanical aspects of these transfers of responsibility remain to be resolved.

the individual accurately and completely fill out the form, provide a social security number, if any, and sign the form under penalties for not answering truthfully. A similar requirement would apply to the INS in connection with individuals who give notice to the INS of their intent to terminate residency.

This recommendation would improve the present-law rules by denying the tax benefits of citizenship relinquishment or residency termination unless and until the information necessary for the IRS to enforce the alternative tax regime is provided.

3. Provide a sanction for individuals subject to the alternative tax regime who return to the United States for extended periods

The Joint Committee staff recommends that a former citizen or former long-term resident who is subject to the alternative tax regime and who is present in the United States for more than 30 days in any calendar year during the 10-year period after citizenship relinquishment or residency termination be treated as a U.S. resident for that calendar year and be subject to U.S. Federal tax on a worldwide basis.

Background

Under present law, resident noncitizens generally are subject to U.S. tax on a worldwide basis for U.S. Federal income, estate, and gift tax purposes. For U.S. Federal income tax purposes, a noncitizen generally is considered to be a resident if the individual is a lawful permanent resident (i.e., a green card holder), or the individual spends a significant amount of time in the United States under a "substantial presence" test. The "substantial presence" test treats an individual as a resident if he or she is present in the United States for 31 or more days during the current calendar year and was present in the United States for a substantial period of time -- 183 or more weighted days during a three-year period weighted toward the current year.[589] In general, for purposes of determining residency for income tax purposes, an individual is treated as being present in the United States on any day if the individual is physically present in the United States at any time during such day, although several exceptions apply.[590] Special residency rules apply for estate and gift purposes. In general, an individual is considered to be a

[589] An individual meets the 183-day part of the test if the sum of: (1) the days present during the current calendar year; (2) one-third of the days present during the preceding calendar year; and (3) one-sixth of the days present during the second preceding calendar year, equals or exceeds 183 days. Presence for 122 days (or more) per year over the three-year period would be sufficient to trigger the test.

[590] For example, certain days of physical presence are excluded in the case of certain foreign government-related individuals, teachers, trainees, students, professional athletes temporarily present to compete in charitable events, and individuals who are physically unable to leave due to a medical condition that arose while present in the United States. Secs. 7701(b)(3)(D), 7701(b)(5).

resident of the United States for estate and gift tax purposes if the individual is "domiciled" in the United States.[591]

Individuals who relinquish citizenship or terminate residency for tax reasons often do not want to fully sever their ties with the United States. In other words, they hope to retain some of the benefits of citizenship or residency without being subject to the U.S. tax system as a citizen or resident. Under present law, these individuals generally may continue to spend significant amounts of time in the United States following citizenship relinquishment or residency termination -- approximately four months every year -- without being treated as a U.S. resident.

Joint Committee staff recommendation

The Joint Committee staff believes that present law provides insufficient deterrent to citizenship relinquishment or residency termination for individuals who desire to maintain significant ties with the United States. Accordingly, the Joint Committee staff recommends that a former citizen or former long-term resident who is subject to the alternative tax regime and who is present in the United States for more than 30 days in any calendar year during the 10-year period following citizenship relinquishment or residency termination be treated as a U.S. resident for that calendar year and thus be subject to U.S. Federal income tax on a worldwide basis.[592]

Similarly, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, and the individual dies during that year, he or she would be considered to be a U.S. resident, and the individual's worldwide estate would be subject to U.S. estate tax. Likewise, if an individual subject to the alternative tax regime is present in the United States for more than 30 days in any year during the 10-year period following citizenship relinquishment or residency termination, the individual would be subject to U.S. gift tax on any transfer of his or her worldwide assets by gift during that year.

For purposes of these rules, an individual should be treated as present in the United States on any day if such individual was physically present in the United States at any time during that day, with no exceptions. The present-law exceptions from being treated as present in the United States for residency purposes would not apply in this context.[593]

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[591] An individual is domiciled in the United States if the individual (1) is living in the United States and has the intention to remain in the United States indefinitely; or (2) has lived in the United States with such an intention and has not formed the intention to remain indefinitely in another country.

[592] Consistent with this approach, consideration also could be given to taxing a former citizen or former long-term resident who is subject to the alternative tax regime on a worldwide basis for the entire year of citizenship relinquishment or residency termination if he or she is present in the United States in the year of citizenship relinquishment or residency termination for more than 30 days. Cf. Treas. Reg. sec. 1.871-13.

[593] *See*, e.g., secs. 7701(b)(3)(D), 7701(b)(5) and 7701(b)(7)(B)-(D).

The Joint Committee staff believes that this recommendation would substantially reduce the incentives to relinquish citizenship or terminate residency for individuals who desire to maintain significant ties to the United States. At the same time, the proposal would not interfere unduly with non-tax-motivated individuals who may desire to relinquish citizenship or terminate residency precisely for the purpose of severing their ties with the United States in favor of another country to which they are more strongly connected.

4. Impose gift tax with respect to certain closely held foreign stock

> **The Joint Committee staff recommends that gifts of certain closely held stock of a foreign corporation by an individual subject to the alternative tax regime be subject to U.S. gift tax to the extent that the foreign corporation holds U.S.-situated assets.**

Background

Under present law, estates of nonresident noncitizens are subject to U.S. estate tax on U.S.-situated property. For these purposes, stock in a foreign corporation generally is not treated as U.S.-situated property, even if the foreign corporation itself owns U.S.-situated property. However, a special estate tax rule applies to former citizens and former long-term residents who are subject to the alternative tax regime. Under this rule, certain closely-held foreign stock owned by the former citizen or former long-term resident is includible in his or her gross estate to the extent that the foreign corporation owns U.S.-situated assets, if the former citizen or former long-term resident dies within 10 years of citizenship relinquishment or residency termination. This rule prevents former citizens and former long-term residents who are subject to the alternative tax regime from avoiding U.S. estate tax through the expedient of transferring U.S.-situated assets to a foreign corporation (subject to income tax on any appreciation under section 367).

The special estate tax rule applies if the former citizen or former long-term resident who is subject to the alternative tax regime owns directly, at death, 10 percent or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation, and, directly or indirectly, more than 50 percent of (1) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (2) the total value of the stock of such corporation. If this stock ownership test is met, then the estate of the former citizen or former long-term resident includes that proportion of the fair market value of the foreign stock owned by the decedent at death, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at death) bears to the total fair market value of all assets owned by such foreign corporation (at death).[594]

No analogous rule applies for gift tax purposes, despite the fact that the concerns relating to the transfer of U.S.-situated assets to foreign corporations are equally present in this context. Thus, under present law, former citizens and former long-term residents who are subject to the alternative tax regime and who wish to make a gift of U.S.-situated property can transfer such

[594] Sec. 2107(b).

property to a foreign corporation (subject to income tax on any appreciation under section 367), and then make a gift of stock in the corporation free of gift tax. In this manner, a higher-rate transfer tax based on the total value of the property generally may be avoided at the cost of paying a lower-rate income tax based only on the appreciation of the property.

Joint Committee staff recommendation

The Joint Committee staff recommends that gifts of certain closely-held foreign stock by a former citizen or former long-term resident who is subject to the alternative tax regime be subject to gift tax if made within the 10-year period after citizenship relinquishment or residency termination. The terms of this special gift tax rule would be similar to those of the special estate tax rule. This proposal would create parity between the estate tax and the gift tax in this regard and would combat a well-known method of gift tax avoidance.

The gift tax rule would apply if the former citizen or former long-term resident owns directly, before making the gift, 10 percent or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation, and, directly or indirectly, more than 50 percent of (1) the total combined voting power of all classes of stock entitled to vote in the foreign corporation, or (2) the total value of the stock of such corporation. If this stock ownership test is met, then taxable gifts of the former citizen or former long-term resident would include that proportion of the fair market value of the foreign stock transferred by the individual, at the time of the gift, which the fair market value of any assets owned by such foreign corporation and situated in the United States (at the time of gift) bears to the total fair market value of all assets owned by such foreign corporation (at the time of gift).

This special gift tax rule would apply to a former citizen or former long-term resident who is subject to the alternative tax regime and who owns stock in a foreign corporation at the time of the gift, regardless of how such stock was acquired (e.g., whether issued originally to the donor, purchased, or received as a gift or bequest).

5. Impose annual return requirement

Require former citizens and former long-term residents who are subject to the alternative tax regime to file an annual return for each of the 10 years following citizenship relinquishment or residency termination

Background

Under present law, U.S. citizens who relinquish citizenship and long-term residents who terminate residency generally are required to provide information about their assets held at the time of their citizenship relinquishment or residency termination. If the collective fair market value of the former citizen's or former long-term resident's assets exceeds $500,000, then detailed information about the individual's and assets must be provided. However, this information generally is required to be provided only once.

Former citizens and former long-term residents who are subject to the alternative tax regime also are required to file annual income tax returns, but only in the event that they owe

U.S. Federal income tax. If a tax return is required, the former citizen or former long-term resident is required to provide the IRS with a statement setting forth (generally by category) all items of U.S.-source and foreign-source gross income, but no detailed information with respect to all assets held by the individual.

The Joint Committee staff believes that these information-reporting and return-filing provisions fail to provide the IRS sufficient information to enable it to monitor effectively the compliance of former citizens and former long-term residents with the alternative tax regime.

Joint Committee staff recommendation

The Joint Committee staff recommends that former citizens and former long-term residents be required to file an annual return for each year following citizenship relinquishment or residency termination in which they are subject to the alternative tax regime. The annual return would be required even if no U.S. Federal income tax is due. The annual return would require certain information, including information on the permanent home of the individual, the individual's country of residency, the number of days the individual was present in the United States for the year, and detailed information about the individual's income and assets that are subject to the alternative tax regime.

In general, former citizens and former long-term residents who are subject to the alternative tax regime would be required to provide annual income and balance sheet information on their U.S. assets, as well as foreign assets that are subject to U.S. tax under the alternative tax regime. This requirement would include information relating to foreign stock potentially subject to the special estate tax rule of section 2107(b) (and the analogous gift tax rule recommended above by the Joint Committee staff).

Obtaining annual information on the income and assets of former citizens and former long-term residents who are subject to the alternative tax regime would permit the IRS to monitor more effectively both the income generated by assets as well as any dispositions of assets that may be subject to U.S. tax. In addition, an annual filing would provide the IRS with up-to-date address and residency information.

6. Transition issues

The Joint Committee staff recognizes that transition issues would have to be addressed in connection with implementing the above recommendations. First, any Joint Committee staff recommendations that are adopted should apply on a prospective basis. Second, any Joint Committee staff recommendations that would override any conflicting treaty provisions should be given the same treatment as present-law section 877 (i.e., such conflicting treaty provisions would be overridden until the tenth anniversary of the enactment of the 1996 tax legislation applicable to former citizens and former long-term residents).

Third, the Joint Committee staff recommends an immediate moratorium on the issuance by the IRS of the "fully submit" category of rulings under IRS Notice 98-34. Under this category of rulings, the IRS loses a statutory presumption in its favor, but declines to reach an opinion as to the central determination it is required to make in lieu of that presumption (i.e., the determination of taxpayer purpose).[595]

[595] As discussed in Part VII.B, above, "fully submit" rulings accounted for approximately half the rulings issued by the IRS under Notice 98-34 through July 1, 2002.